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This cable contains Business Proprietary Information.

¶1. Embassy Abu Dhabi and Consulate General Dubai welcome the April 6-8 visit of Under Secretary for Economic, Energy, and Agricultural Affairs Reuben Jeffery.

Economic and Financial Growth Strong

¶2. (U) UAE economic growth continues to be strong, on the back of high oil prices, increasing foreign and domestic investment, and a construction boom. Nominal GDP hit about USD 190 billion in 2007 and according to initial UAEG estimates, real GDP growth in 2007 was 7.4%. Despite holding nine percent of the world's proven oil reserves, the UAE has followed an aggressive policy of economic diversification to the point where only about 35 percent of nominal GDP comes directly from the production of crude oil and gas. Fixed investment in 2007 increased by 19 percent to reach USD 39.4 billion (including about 18 percent into the real estate sector, reflected in the forest of cranes throughout Dubai and to a lesser extent the rest of UAE).

¶3. (U) As strong as these numbers are, the UAE has ambitious growth plans. The Emirate of Dubai's strategic plan forecasts 11 percent real growth through 2015. Dubai is building the world's tallest building, the world's biggest airport and the world's biggest artificial island. For its part, the Emirate of Abu Dhabi is also starting to flex its economic muscles. There are between USD 330 and USD 350 billion in development projects in the pipeline in the Emirate of Abu Dhabi alone, including a brand new world class port facility and what may eventually be the world's largest aluminum plant. In addition, the Emirate of Abu Dhabi has ambitious plans to increase oil production capacity to four million barrels per day by the 2014 timeframe.

What are the risks?

¶4. (SBU) Although the prognosis for the UAE is generally positive, there are geopolitical and economic risks. Thus far, the UAE has benefited from being an oasis of stability in a dangerous neighborhood. A major terrorist attack or sharp increase in tensions with Iran would likely cut economic growth, especially in the UAE's growing tourism and transport business. The UAE is keenly aware of threats to its economy. The Emirate of Abu Dhabi has established the Critical National Infrastructure Authority to protect the Emirate's vital facilities, including oil and gas installations, power

plants/desalination facilities, and airports/sea ports.

¶5. (SBU) Inflation, currently estimated by some analysts at around 11 percent, presents a serious economic risk. The rapid development of the UAE has put serious pressure on the housing market, causing sharp increases in rents. It has also put pressure on all types of goods from foodstuffs to steel and concrete. The vast number of projects in the UAE, and in the GCC generally, is putting extreme stress on human and material resources, thus increasing costs. These increased costs are squeezing the UAE's largely expatriate middle class and making it more difficult for the UAE to attract necessary human capital. Business contacts increasingly complain about the costs involved in attracting both skilled and unskilled workers. In at least some cases, they have lost workers when salaries and benefits failed to match rising costs of living. In other cases, lower paid workers are sending family members home as increasing schooling and housing costs force expenditure cutbacks. UAE officials have responded by imposing (or negotiating) price caps on basic household items, rent caps in Abu Dhabi and Dubai, and by raising federal salaries by 70 percent.

¶6. (SBU) Rapid economic growth is also putting serious pressure on the UAE's infrastructure, particularly on power generation. Abu Dhabi's water and electricity company's recent demand growth forecasts are for 6.7 percent average annual growth for the next 23 years. (Note: this figure does not include "off grid" projects such as the new aluminum plant. End note.) Moody's estimates that the Emirate of Dubai will need to triple its power generation capacity over the next ten years. Although the northern emirates are starting from a much lower base, they also have ambitious development plans which are already overstressing their power generation capacity. The mismatch between development and power in the northern emirates has hurt a U.S. investor, Guardian Industries, which built a USD 150 million float glass plant in the Emirate of Ras Al-Khaimah only to discover that the Federal Electricity and Water Authority was unable to provide needed power. The Embassy and Consulate General intervened on behalf of Guardian, which is now receiving some of its required power from FEWA, but is required to use expensive generators for the rest.

¶7. (SBU) The sharp increases in projected power and water demand will require significant investments in power and desalination plants, but also raise a more fundamental question of feedstock sources. Although the UAE has the fifth larges proven natural gas reserves in the world, it is not producing enough natural gas to meet its current needs (including reservoir management). Oil and gas belong to the seven individual emirates, not the UAE as a whole, and are unevenly distributed among the emirates (with Abu Dhabi having around 93-94 percent of the total reserves). Abu Dhabi does not produce enough gas to meet the demands of all of the other emirates.

¶8. (SBU) Abu Dhabi has several projects underway to increase gas production available to power generation projects, including building a pipeline to connect offshore fields to the UAE mainland and a major onshore sour gas development project. (Note: Although the deal has not been publicly announced or signed, U.S. firm ConocoPhillips has won the sour gas development project. End note.) In addition, the UAE currently imports two billion cubic feet per day of natural gas from Qatar via pipeline (the Dolphin Project, with Occidental Petroleum holding a 24.5 percent stake). Despite these projects, UAE officials estimate that the planned gas production will still be insufficient to meet projected demand growth and are examining alternatives. Abu Dhabi is considering the development of peaceful nuclear power and has engaged in discussions with the USG about potential assistance. It has also signed a nuclear cooperation agreement with the Government of France, though contrary to news reports, not with French companies.

The Currency Peg

¶9. (SBU) There is increasing public pressure on the UAEG to at least revalue the dirham, if not drop the dollar peg in favor of a peg to a trade-weighted basket of currencies. There are almost daily articles

calling for a revaluation. Many expatriates, especially from Europe and India, have complained about the "double hit" from the increasing local cost of living and the relatively lower income in comparison to their home currencies. Although the Central Bank has asserted that domestic capacity constraints rather than dollar weakness are the main drivers of inflation, several bank economists have argued that low interest rates have sharply increased liquidity and by extension higher prices. Although the counter arguments rarely make the papers, there are those who note that a revaluation would not be cost free to the UAE. Abu Dhabi holds significant overseas financial assets, many dollar- denominated. Revaluing the dirham would reduce the relative value of these assets. It could also harm the UAE's efforts to diversify its economy by potentially making non-oil exports less competitive and making the UAE a less attractive destination for European tourists. Efforts to move to a trade-weighted peg would be hampered by statistical shortcomings and poor information flow from the individual emirates (which track trade) to the federal government.

¶10. (SBU) So far the UAE has steadfastly maintained its peg to the dollar and recently cut its rate by 75 basis points to match the Federal Reserve's cut. UAE officials have also insisted, both publicly and privately, that they are committed to maintaining the peg. They also note that as part of the GCC agreement to create a monetary union by 2010, member states agreed to peg their currencies to the dollar. Any change would need to be a consensus decision. Should another GCC country revalue or drop the peg, however, the pressure on the UAEG would increase sharply.

Investment and Sovereign Wealth Funds

¶11. (SBU) UAE institutions are major foreign investors, with the Emirate of Abu Dhabi's Sovereign Wealth Fund (SWF), the Abu Dhabi Investment Authority (ADIA), widely regarded as one of the world's largest SWFs. Since its establishment in 1976, ADIA has followed a largely passive, diversified, long-term strategy. Since, constitutionally, natural resources belong to the individual emirates rather than the UAE as a whole, SWFs and other investment vehicles are emirate-level rather than federal-level organizations, although the UAE established the Emirates Investment Authority in November 2007 to invest the assets of the federal government.

¶12. (SBU) Although ADIA is a largely passive, portfolio investor, other UAE investment organizations and State-owned enterprises take larger stakes in overseas investments. DP World's ultimately failed attempt to purchase P&O's U.S. assets is still a source of local resentment, although UAE-based government-owned investors have subsequently made several high-profile acquisitions in the U.S. In your conversations with UAE officials, you are likely to hear concerns about "political risk" premiums for foreign investment in the U.S.

¶13. (SBU) Abu Dhabi officials have consistently assured us that the

Abu Dhabi Government would never use its foreign investments as a foreign policy tool. ADIA and Government of Abu Dhabi officials worked closely with the Treasury Department and the Government of Singapore to develop a series of best practice policy principles for SWFs and for countries receiving SWF investment. Abu Dhabi officials jointly released these principles with Treasury Secretary Paulson and officials from Singapore on March 20 as a way to encourage the IMF and the OECD's work to develop voluntary best practices for both SWFs and inward investment regimes.

¶14. (SBU) With regard to investment in the UAE, the investment climate still favors locals. Outside the UAE's many free zones, there is still a legal requirement to have local ownership of 51 percent of a company or industrial enterprise. The UAEG has been considering revisions to the Commercial Companies Law and a new FDI law, which reportedly would permit greater foreign ownership in certain sectors, but those laws have not yet been passed. The inclusion of natural resources became a stumbling block in our efforts to conclude an FTA with the UAE. That said, the Emirate of Abu Dhabi has always allowed foreign equity participation in the oil

sector. ExxonMobil has a 9.5 percent stake in the onshore oil company and a 28 percent stake in the offshore Upper Zakum field. ADNOC has all but concluded an agreement with ConocoPhilips to develop an onshore sour gas field, although neither party has officially announced the deal. This would be the first time that a foreign company would have access to an upstream gas development project.

Strengthening the Economic Relationship

¶15. (U) The U.S.-UAE economic and trade relationship remains strong with USD 12.9 billion in two-way trade and the U.S. running almost a USD 10.3 billion trade surplus. There are over 750 U.S. firms physically present in the UAE, many serving the wider region.

¶16. (SBU) Although both parties decided last year that we would not be able to conclude a Free Trade Agreement in the time permitted before the lapse of trade promotion authority, FTA negotiations made progress in a number of areas, including in making revisions to the UAE's Agency Law that tied the length of an agency agreement to the length of the contract between the foreign principal and the UAE agent. The revised Agency Law also required mutual consent to renew an agreement, where previously the UAE agent could unilaterally re-register the agreement. Issues related to dispute settlement and treatment of natural resources in the investment chapter had not been resolved, nor had issues related to opening up the telecommunications sector. In addition, the UAE's lack of rights of association and collective bargaining remained a serious problem.

¶17. (SBU) The UAE and the U.S. agreed to a TIFA-Plus arrangement to further promote trade ties. The two sides held the first council meeting in late June of 2007, but have not held subsequent meetings. The UAE has agreed to participate in Anti-Counterfeiting Trade Agreement negotiations with the U.S., but there has been little visible progress in other areas of TIFA-Plus engagement. UAE economic engagement continues in other fora, however, for example through ADIA's cooperation with the Department of Treasury.

¶18. (SBU) The UAE had expressed interest in exploring a Bilateral Investment Treaty (BIT). The USG had expressed concern that issues that had caused problems in the FTA investment chapter would cause similar problems with the BIT. The UAE has not pushed for BIT negotiations, but at least some of the UAE's negotiators have privately said that they see more flexibility in the model BIT text than in the FTA investment chapter.

¶19. (SBU) The UAE's February cabinet reshuffle has also changed the UAE's economic team. Sheikha Lubna Al-Qasimi, who as Minister of Economy was a co-chair of the UAE negotiating team, is now the head of a newly created Ministry of Foreign Trade. Minister of State for Financial and Industrial Affairs, Dr. Mohamed Khalfan bin Kharbash, the other FTA co-chair, was replaced by Obaid Humaid Al-Tayer, who as head of the Dubai Chamber of Commerce and Industry had publicly expressed skepticism about the benefits of the FTA to UAE businesses. These shake-ups (and changes in USTR) will likely complicate near-term efforts on the trade front, but could also give us an opportunity to re-energize our overall economic cooperation. A first step would be an open discussion with the UAE on core needs and interests moving forward.

Quinn